
FISCAL POLICY

After several years of stimulus, fiscal policy is tightening in 1987, and it should continue to tighten if the Congressional Budget Resolution for 1988 is adopted, as assumed in the economic forecast. In the long run, smaller deficits should help to improve national saving, domestic investment, and the foreign trade balance. In the short run, however, fiscal restraint may tend to slow the growth in output and employment.

The federal deficit is expected to decline from \$221 billion in fiscal year 1986 to \$157 billion in 1987. Based on the tax and spending policies of the budget resolution and the economic outlook discussed in this report, the deficit is expected to decline further to \$146 billion in 1988 and to \$108 billion by 1990. On average, about half of the 1988-1990 deficit reductions embodied in the Budget Resolution reflect measures to limit spending growth, while the rest stem from as yet unspecified revenue increases. Despite the decline in the size of the federal deficit under the budget resolution, the projected ratio of federal debt to GNP does not begin to decline until 1990.

To provide a better measure of discretionary fiscal policy, deficit figures have also been calculated on the basis of nominal potential GNP, which removes cyclical influences. Such standardized-employment deficit estimates, presented in Table I-1 and Figure I-1, show a sharp decline from a postwar high of 4.3 percent of potential nominal GNP in 1986 to 2.7 percent in 1987, followed by a smaller decline to 2.4 percent in 1988. ^{1/}

A number of special factors, however, affect the reported revenue and outlay totals in a manner that distorts the pattern of fiscal restraint from 1986 to 1988. For example, asset sales (which should be excluded from the standardized-employment deficit because such financial transactions have little effect on the economy) vary from year to year (see Table II-7). In addition, the large bulge in capital gains tax revenues this year is a non-recurring event attributable to a change in the tax law. ^{2/} The shift of certain federal payments by a few days, from 1987 to 1988, also creates a misleading year-to-year pattern of deficits. When the projected outlays and revenues are adjusted for asset sales, all the budgetary effects of tax

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1. The calculation of potential real GNP is described in Appendix B. Nominal potential GNP is real potential GNP multiplied by the projected GNP deflator.
 2. The Tax Reform Act of 1986 repealed preferential tax treatment of capital gains in 1987 and subsequent years. This change encouraged the sale of appreciated assets in 1986 and resulted in additional Treasury receipts in 1987.

TABLE I-1. MEASURES OF FISCAL POLICY
(By fiscal year, on a unified budget basis)

Standardized-Employment Deficit	<u>Actual</u> 1986	1987	1988	1989	1990	1991	1992
In Billions of Dollars							
Budget resolution	185	122	117	113	85	n.a.	n.a.
Adjusted for tax re- form and other special factors <u>a/</u>	187	156	98	94	80	n.a.	n.a.
Baseline	185	122	155	166	154	147	139
Adjusted for tax re- form and other special factors <u>a/</u>	187	156	141	146	148	148	142
In Percent of Potential GNP							
Budget resolution	4.3	2.7	2.4	2.2	1.6	n.a.	n.a.
Adjusted for tax re- form and other special factors <u>a/</u>	4.4	3.5	2.0	1.8	1.5	n.a.	n.a.
Baseline	4.3	2.7	3.2	3.2	2.8	2.5	2.2
Adjusted for tax re- form and other special factors <u>a/</u>	4.4	3.5	2.9	2.9	2.7	2.6	2.3

SOURCE: Congressional Budget Office.

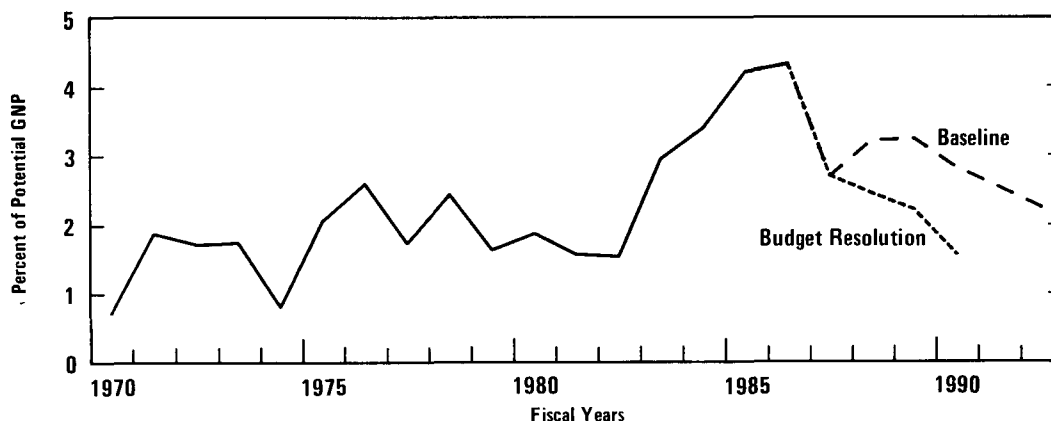
NOTE: n.a. = not applicable.

- a. Special factors include asset sales, loan prepayments, the accelerated release of Outer Continental Shelf escrow funds, the military pay-date delay, the Medicare payment delay, and the advancement of the final revenue-sharing payment.

reform, and the shifting of payments, the pattern of fiscal policy looks quite different (see Table I-1). ^{3/} In particular, after making these adjustments,

3. While the Tax Reform Act increases revenues in some years and reduces them in others, it is expected to be approximately revenue neutral in the long run. The adjustment made in Table I-1 removes those year-to-year fluctuations.

Figure I-1.
Standardized-Employment Deficit



SOURCE: Congressional Budget Office.

fiscal policy under the budget resolution shows steadily increasing restraint between 1986 and 1988.

The standardized-employment deficit is projected to decline to 1.6 percent of nominal potential GNP by 1990, assuming continuation of the tax and spending policies of the Budget Resolution for 1988. ^{4/} This amount represents substantially less restraint than would be realized under the targets of the Balanced Budget and Emergency Deficit Control Act of 1985 (popularly known as the Gramm-Rudman-Hollings targets), which would lower the standardized-employment deficit to 1.7 percent of potential GNP in 1988, and to 0.3 percent in 1990. On the other hand, the policies of the budget resolution result in more restraint than would occur under the baseline policy path (see Table I-1 and Chapter II).

As previous CBO reports have indicated, there is widespread agreement that in the long run smaller federal deficits would be conducive to the formation of private domestic wealth and to higher future living standards. Views differ widely, however, as to the short-run effect of fiscal restraint. Some analysts argue that fiscal restraint could reduce output and employment significantly; others claim that it would have little if any effect. One of the considerations stressed in earlier reports has been that in a world of

4. The projected path of yearly restraint is essentially the same when interest payments and Federal Reserve earnings are excluded from the calculations.

flexible exchange rates the adverse effects of fiscal restraint on output and employment would be diminished by the resulting dollar depreciation and the subsequent improvement of the trade balance. At present, however, monetary policy is apparently aimed at preventing a too rapid decline in the dollar; therefore, this offset to fiscal restraint may be less significant.

The net effect of the Tax Reform Act of 1986 on economic growth over the next 18 months is uncertain. The act, an extensive revision of the tax code, is likely to have a positive long-run impact on economic efficiency. It is difficult to determine, however, what the overall effect on aggregate demand in the short run will be because some aspects of the legislation are favorable to short-run demand while others will temporarily restrain growth. For example, the new tax provisions increased the cost of capital for business fixed investment and multifamily housing, but they also strengthened disposable personal income. Investment, particularly investment in business and certain types of residential structures, is likely to be adversely affected, but the reduction in personal income taxes will tend to keep consumption from slowing as much as it would have in the absence of tax reform. ^{5/} The act's overall impact is therefore assumed to be essentially neutral in this forecast.

THE DOLLAR, MONETARY POLICY, AND INTEREST RATES

Monetary policy and developments in financial markets were closely linked to the behavior of the dollar in the first half of 1987. The drop in the dollar was a major factor in the sudden jump in interest rates, and the extent of the dollar's fall encouraged the Federal Reserve Board to become less accommodative in its monetary policy. This stance is likely to continue as the Board attempts to keep the dollar from falling too rapidly, and consequently some upward pressure on interest rates is probable in the short run.

Monetary Policy Background. In 1986, the Federal Reserve pursued a monetary policy it characterized as "accommodative." ^{6/} The various monetary

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5. See Congressional Budget Office, "Economic Impacts of the Tax Reform Act of 1986: Short-Run and Long-Run Perspectives" (Staff Working Paper, June 1987).
 6. See the statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 19, 1987, *Federal Reserve Bulletin*, vol. 73 (April 1987), pp. 282-289.

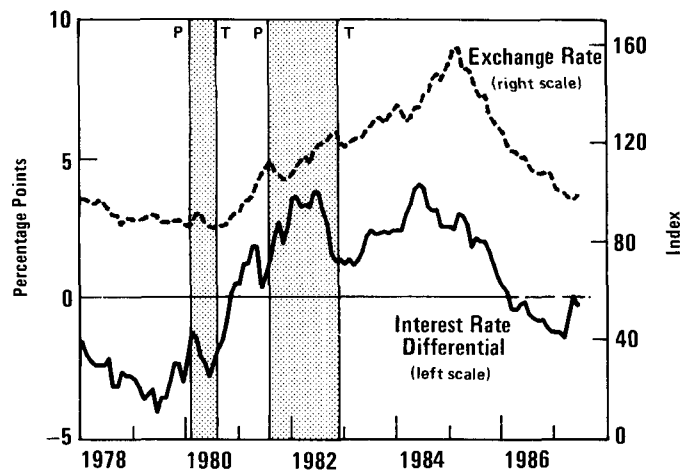
aggregates, especially M1, grew at a relatively rapid pace, and the discount rate was reduced four times by a total of two percentage points--roughly in line with reductions in market interest rates. Market rates of interest continued to decline into early 1987, reaching their lowest levels in nearly a decade. In addition, nonborrowed reserves held by depository institutions grew dramatically throughout 1986, increasing at a rate of about 25 percent. The generous provision of reserves and the expansion in money occurred, however, in an environment of restrained economic growth and declining inflationary pressures.

The velocity of M1 (that is, the ratio of nominal GNP to the M1 monetary aggregate) declined much more in 1986 than expected, continuing the relative unpredictability of the relationship in the 1980s. On the basis of historical relationships before 1980, the rapid growth of the monetary aggregates that occurred in 1986 should generate higher inflation this year. But the recent experience with changes in velocity suggests that monetary growth rates are for the time being poor predictors of inflation. In any event, the Federal Reserve allowed the growth of all monetary aggregates to slow in the first half of this year.

Private Capital Flows and the Dollar. The decline in the real value of the dollar against the currencies of major industrial countries in 1986, and against the currencies of both the major industrialized countries and the newly industrialized countries early in 1987, indirectly reflected the unwinding of a number of macroeconomic conditions that had earlier resulted in a very strong dollar. These conditions, which were discussed at length in previous CBO reports, resulted in high real rates of return on dollar-denominated assets relative to returns abroad in the first half of the 1980s, caused large net private capital inflows to the United States, and drove up the value of the dollar (see Figure I-2). In real (inflation-adjusted) foreign currency terms, claims against U.S. residents by private foreign residents grew at an average rate of 20 percent per year from the end of 1979 to the end of 1985, whereas similarly calculated claims of U.S. residents against private foreign residents grew less than half as fast. The resulting pace of accumulation of net claims against the United States was clearly unsustainable in the long run, simply because it would have required dollar-denominated assets to comprise a rapidly growing and ever-increasing share of private foreign portfolios.

The easing of U.S. monetary policy in 1986, coupled with moderate economic growth and the prospect of lower federal deficits, resulted in reductions in U.S. interest rates relative to foreign rates. This reduction was a major reason why private net capital inflows slowed considerably in 1986 (though the inflows were still large compared with the 1970s). The downward pressure on the dollar resulting from this slowdown was partly offset

Figure I-2.
The Exchange Rate
and Relative
Interest Rates



SOURCES: Congressional Budget Office; Federal Reserve Board; International Monetary Fund.

NOTE: The exchange rate is a trade-weighted average of dollar exchange rates. The real interest-rate differential is the difference between long-term real interest rates for the United States and a GDP-weighted average for other major industrial countries. Long-term real interest rates are long-term nominal interest rates (on government bonds), adjusted for expected inflation rates. Expected inflation is proxied by a two-year centered moving average of actual and projected CPI inflation rates.

by large-scale foreign official intervention during that year. Foreign central banks greatly increased their holdings of dollar assets. In the first quarter of 1987, net private demand for dollar-denominated assets probably slowed a great deal more. ^{7/}

Recent Developments in Interest Rates and Monetary Policy. The Federal Open Markets Committee (FOMC) did not specify a target range for M1 for 1987. It was still concerned, however, about the prospect of future inflation in light of the rapid pace of money expansion in 1986, and felt that some slowdown in money growth was necessary in 1987. This concern was evident in the slightly lower ranges that the FOMC set for M2 and M3 for 1987.

Massive intervention by central banks in foreign exchange markets early this year was ineffective in stopping the decline of the dollar. Moreover, in response to both an increased concern about the inflationary effect of further depreciation and relatively high rates of inflation in the first few months of the year, interest rates rose sharply in the second quarter to levels higher than they had been in over a year. Although the rise in rates occurred across the whole spectrum of maturities, it was much more pronounced for long-term securities (see Figure I-3). The steepening of the

7. Reported net private capital inflows to the United States rose slightly in the first quarter, but this increase was probably the result of temporary factors that did not reflect the underlying private demand for dollar-denominated assets.

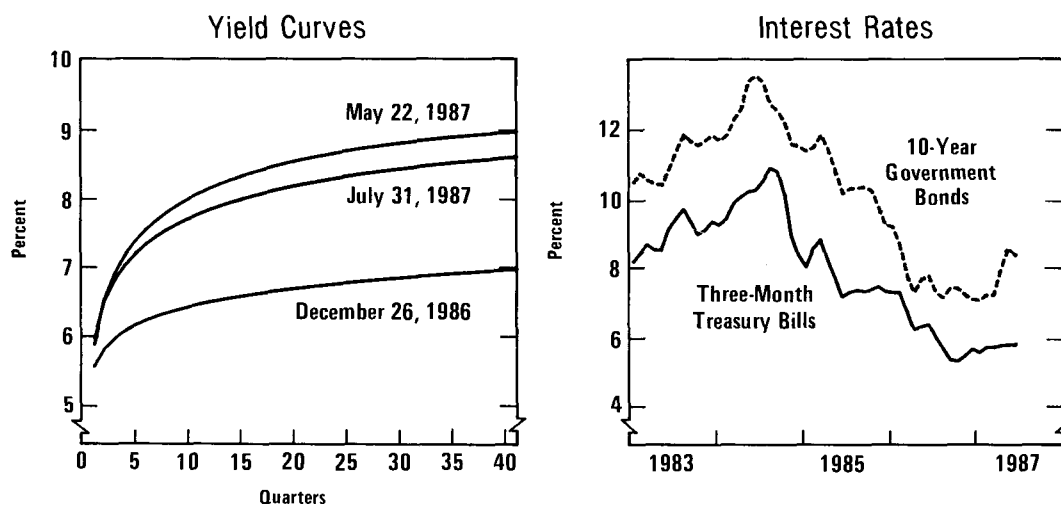
term structure of interest rates (that is, long-term rates increasing more than short-term rates) is consistent with expectations that inflation will increase.

The sharp drop in the value of the dollar early in 1987 and the prospects of higher inflation apparently forced the Federal Reserve into a slightly less accommodating monetary policy. There were a number of indications of a slight tightening. First, the spread between the federal funds rate (the rate banks charge one another to lend reserves overnight) and the discount rate increased, suggesting some willingness by the Federal Reserve to allow reserves markets to tighten. Second, the amount of borrowing by depository institutions from the Federal Reserve increased. Third, the broader monetary aggregates M2 and M3 have grown slowly since January and remain at levels below the lower bound of the target-growth ranges established this year by the FOMC (see Figure I-4).

The tightening of monetary policy in the second quarter of 1987 helped to assure investors, foreign and domestic, that the Federal Reserve is willing to act to protect the dollar and resist inflation. The result was a rekindling of demand for dollar-denominated assets and a strengthening of the dollar, at least temporarily.

Figure I-3.

Recent Movements of Short- and Long-Term Interest Rates



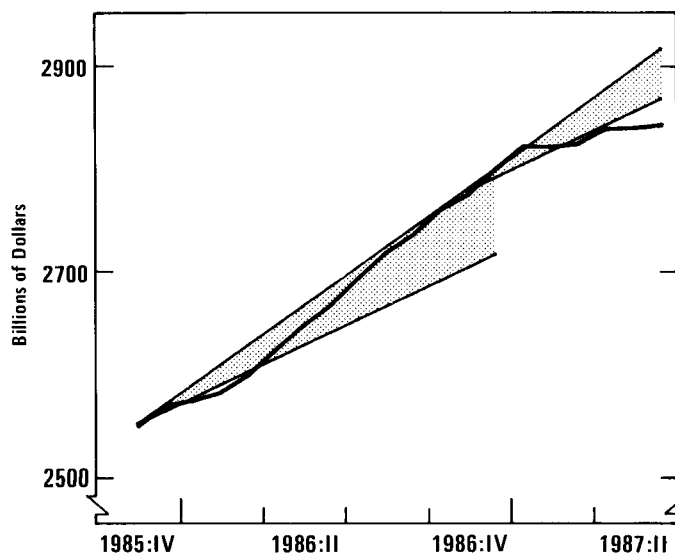
SOURCES: Congressional Budget Office; Federal Reserve Board.

^aThese curves were fitted to weekly average yields on Treasury instruments using a logarithmic function described by Bradley and Crane in the *Journal of Bank Research*, Spring, 1973.

Outlook for the Dollar and Interest Rates. The forecast and medium-term projection both assume that, as implied in the budget resolution, there will be further progress in reducing federal budget deficits relative to GNP. This improvement would allow a gradual reduction of U.S. interest rates relative to those of other major countries. Private residents of the rest of the world are assumed to respond by reducing the rate of accumulation of their net claims against the United States (when measured in real foreign-currency terms) from the 1986 rate to a pace nearer the growth rate of real foreign GNP by 1992. Changes in official net claims against the United States are assumed to be minor after 1988. The gradual transition in the rate of accumulation of dollar-denominated assets by private foreigners would require, according to CBO estimates, a trend rate of dollar depreciation against major foreign currencies of about 5 percent per year through the projection period. Even with the assumed reduction in the rate of foreign accumulation of dollars, total U.S. net foreign liabilities will be growing substantially throughout the projection period, because the current account deficit will continue to grow in nominal terms.

The long-run trend of the dollar assumed in the forecast and projections is only one of many possibilities. Exchange rates depend on the relative demand for capital, and each country's net capital demand depends in turn on private and government saving behavior, investment opportunities, international competitiveness, and so on. For example, if public debt

Figure I-4.
M2 Growth and
Targets



SOURCES: Congressional Budget Office; Federal Reserve Board.

NOTE: Shaded areas indicate target ranges. The range was 6% to 9% in 1986, and is 5½% to 8½% in 1987.

in foreign industrial countries were to grow as rapidly in the projection period as it did in the 1970s, less foreign capital would be available for dollar-denominated investment. Some analysts assume that long-run portfolio-balancing objectives require that the U.S. current account be roughly balanced in nominal terms by the early or middle 1990s. ^{8/} If this is the case, a faster trend rate of dollar depreciation than that incorporated in the projections would be necessary.

Although a smooth trend rate of dollar decline is incorporated in the forecast and projections for 1988 to 1992, the actual path is more likely to be irregular, and the dollar could possibly strengthen for a time. Regardless of the actual path, financial markets and Federal Reserve policy will continue to be affected by fluctuations in the dollar. Anticipated tightness of monetary policy through the end of 1987 should put upward pressure on interest rates in the near term. The duration of such a policy, however, will depend primarily on the strength and durability of the economy's growth. Another factor that could affect Federal Reserve policy is the condition of banks and thrifts. Although strains have eased recently, a large number of financial institutions are still extremely weak (see Box I-1). Fear of a sudden worsening of difficulties may constrain Federal Reserve policy.

LABOR MARKETS

Productivity has been growing at a snail's pace during the last four quarters, but job creation has been strong. The unemployment rate fell by seven-tenths of a percentage point in the first seven months of the year, both because of gains in employment and because of a slowdown in the growth of the labor force. This sharp decline has raised concerns about tightness in the labor market, but wage increases have continued to be moderate and other indicators imply that there is still slack in the economy.

On the whole, productivity growth continues to be disappointing. Non-farm business productivity--output per unit of labor--was virtually the same in the second quarter of 1987 as in the second quarter of 1986 (see Figure I-5). In other words, the growth in hours worked (2.6 percent) was roughly equal to the growth in output (2.9 percent).

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8. Rudiger Dornbusch, "Why the Dollar Must Fall Another 30 Percent," *The New York Times* (May 10, 1987), and Paul R. Krugman and George N. Hatsopoulos, "The Problem of U.S. Competitiveness in Manufacturing," *New England Economic Review* (January-February 1987).

BOX I-1 TROUBLED FINANCIAL INSTITUTIONS

A significant percentage of the country's federally insured thrift institutions are in trouble. At the end of 1986, the 3,220 federally insured thrifts had \$1,165 billion in assets. As a group these thrifts have been solvent and profitable; their net worth has recently been increasing faster than their liabilities. But 327 thrifts, with \$88 billion in assets at year-end, had negative net worth and were losing money. Many of these as well as other troubled S&Ls should be closed, and closing them usually involves cash outlays by the Federal Savings and Loan Insurance Corporation (FSLIC). The FSLIC is currently in financial difficulties--with a negative net worth of more than \$6 billion, according to the General Accounting Office.

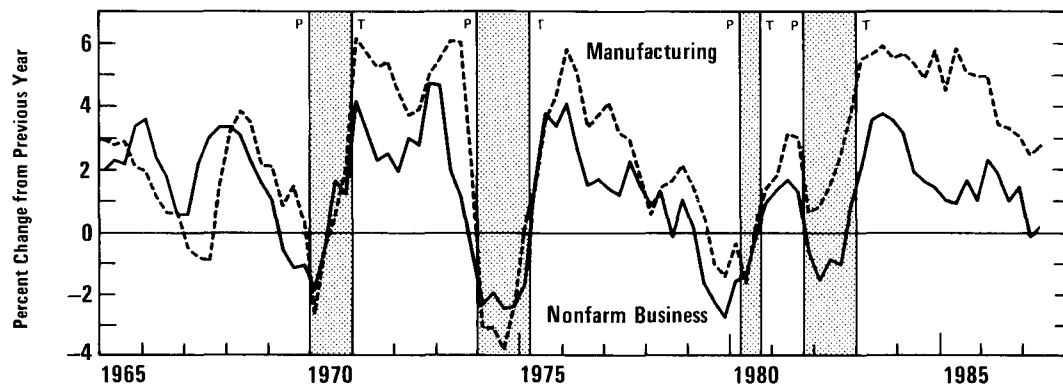
To remedy this situation, the Congress has passed legislation that will enable the FSLIC to be recapitalized in the amount of \$10.8 billion. The cost to the FSLIC of closing 50 thrifts in 1986 exceeded 20 percent of the institutions' total assets. Because of this some analysts estimate that the amount needed to deal with all the currently insolvent but still operating institutions is at least \$21 billion. Moreover, the profits of the healthy institutions may be insufficient to pay the whole cost of recapitalizing the FSLIC, as is currently being contemplated. Insolvent institutions now have an incentive to invest in risky assets, since if the investments pay off they may become solvent, while if they do not--which is more likely--the resulting losses will be borne by the FSLIC. It is therefore important to close insolvent institutions in a timely manner. In any event, the question is not whether insured depositors will be protected from loss but who will pay for resolving the problem.

The commercial banking sector also has some troubled institutions, particularly among those that had loaned heavily in the farm, energy, and international areas. For a number of reasons, the problems in this sector appear to be far less costly and much more manageable than those of the thrifts. First, the most seriously troubled institutions have been the agricultural or farm banks, which are large in number but account for a very small percentage of all commercial bank assets. Second, the recent rise in energy prices has lessened the problems of banks with substantial portions of their loan assets in energy and energy-related activities. Third, banks that are heavily involved in loans to developing countries have recently been increasing their loan-loss reserves, apparently preparing themselves for future write-downs of bad loans. Finally, the commercial banking industry comprises more than 14,000 institutions with nearly \$3 trillion in assets. Compared with the thrifts, relatively few banks are in difficulty and the cost of dealing with them is much less. Moreover, unlike the FSLIC, the Federal Deposit Insurance Corporation (FDIC), which insures deposits at banks, is solvent--with more than \$18 billion available to close the insolvent banks.

The aggregate productivity data mask the difference between the productivity performance in manufacturing and in the service-producing sector. Productivity growth in manufacturing, which is crucial for maintaining competitiveness in international trade, has been relatively good in the 1980s compared with the historical record. It compares well with the growth experienced in the 12 other countries that are tracked by the Bureau of Labor Statistics (BLS); in 1986, U.S. manufacturing productivity growth ranked first for the first time since BLS began compiling the data in 1950. In the service-producing sector, on the other hand, productivity growth--as currently measured--virtually ceased in the early 1970s. The measurement of productivity in the service-producing industries is not fully satisfactory, and productivity in that sector--and the economy as a whole--may be understated. But there is little reason to doubt that productivity growth in the service sector has slowed in the past 15 years.

The slow aggregate growth in productivity in the last year was accompanied by strong job growth. Nonfarm payroll employment has grown by 2.5 percent over the last 12 months, with the growth concentrated in the service-producing industries. Though employment in goods-producing industries grew quickly in the first two years of the recovery, it has been relatively stagnant since early 1985. Reflecting the growing trade deficit, manufacturing employment declined by about 100,000 jobs from late 1985 to mid-1986, and employment in oil drilling and exploration plummeted follow-

Figure I-5.
Productivity Growth



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

ing the drop in oil prices in 1985 and 1986. Since mid-1986, however, manufacturing payrolls have begun to increase slowly (see Figure I-6). In addition, with the recovery in oil prices, employment in energy-producing industries seems to have bottomed out.

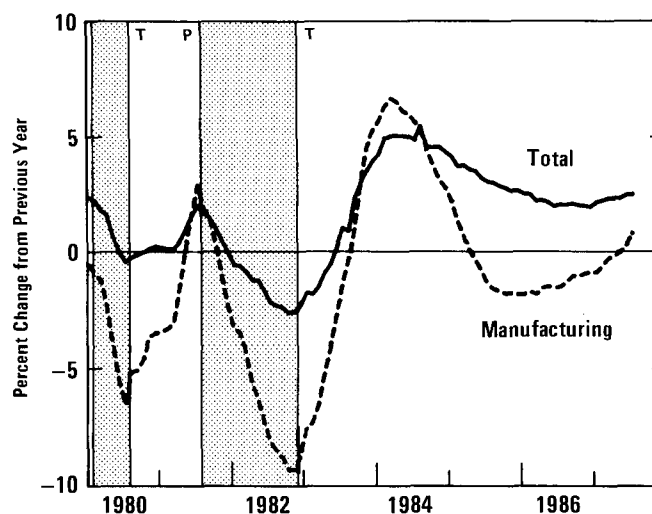
The labor force grew by 1.6 percent over the last 12 months, in part because of continued increases in the labor force participation rate of adult women. A slowing of labor force growth since February, however, accounts for some of the substantial decline in the unemployment rate during the first half of 1987.

The civilian unemployment rate fell from 6.7 percent in December to 6.0 percent in July. The decline has caused some analysts to worry about possible tightness in labor markets and consequent inflationary pressure (see Box I-2). In the 1970s, that level of unemployment might have been considered inflationary, but currently there seem to be few signs of labor market tightness.

PRICES AND WAGES

Consumer price inflation has increased sharply from the 1.1 percent rate that occurred between December 1985 and December 1986. In the first six months of 1987, prices rose at about a 5½ percent annual rate, though prices excluding food, energy, and used cars remained close to the 4 percent to 4½

Figure I-6.
Private Nonfarm
Employment



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

NOTE: Establishment survey data.

BOX I-2 LABOR MARKETS, INFLATION, AND NAIRU

Before the recent drop in the unemployment rate, most economists (including those at CBO) argued that labor market tightness would not be a concern unless the unemployment rate fell to about 6 percent. It now appears that the figure should be revised downward, because there is no convincing evidence that the degree of slack in productive capacity has dropped commensurately with the unemployment rate. The overall manufacturing capacity utilization rate is below the level normally associated with supply constraints, and wage pressures still appear to be moderate.

Although the relationship between the aggregate unemployment rate and inflationary pressures is complex, economists have made rough estimates of the unemployment rate that are likely to be consistent with a stable rate of inflation. This rate, referred to in the January CBO economic report as the stable inflation rate of unemployment, is frequently called NAIRU (for non-accelerating inflation rate of unemployment). NAIRU can vary from year to year as the underlying relationship between the unemployment rate and inflation changes, and numerous factors could affect that relationship.

Changes in some of these factors now seem to justify a reappraisal of the estimate of NAIRU. Among the most important are demographic changes. For a variety of reasons, different groups in the labor force tend to experience different unemployment rates. If a group such as teenagers--who typically exhibit relatively high unemployment rates--grows relative to the labor force as a whole, inflationary pressures will tend to develop at a higher level of aggregate unemployment than if its share in the labor force is stable or falling.

percent rate that has prevailed for the past three years (see Figure I-7). In large part, the increase in overall consumer inflation was attributable to sharply higher energy prices, reflecting the increase in world oil prices. The decline in the exchange rate in the first quarter was probably not a major factor, since relatively little acceleration in nonpetroleum import prices has yet been reported. In the near future, however, those prices are expected to increase sharply, so that even if energy prices stabilize, higher import prices will push up consumer prices.

This recent higher trend in consumer price increases is expected to continue at least through 1988, as the effect of the recent decline in the dollar works its way through to import prices and consumer prices. As a result, inflation as measured by the Consumer Price Index (CPI) is expected to exceed substantially the rate of increase in the GNP deflator (the latter

Similarly, if income transfers to the unemployed significantly affect their willingness to accept work, changes in the availability of unemployment insurance and other income support programs will affect NAIRU. Another factor is the amount of structural unemployment produced by localized declines in employment. The greater the mismatch of workers to jobs, either geographically or occupationally, the higher NAIRU will be. Labor market institutions also play a role: How heavily unionized are workers, and do unions place a higher priority on wage gains or on the size of their membership?

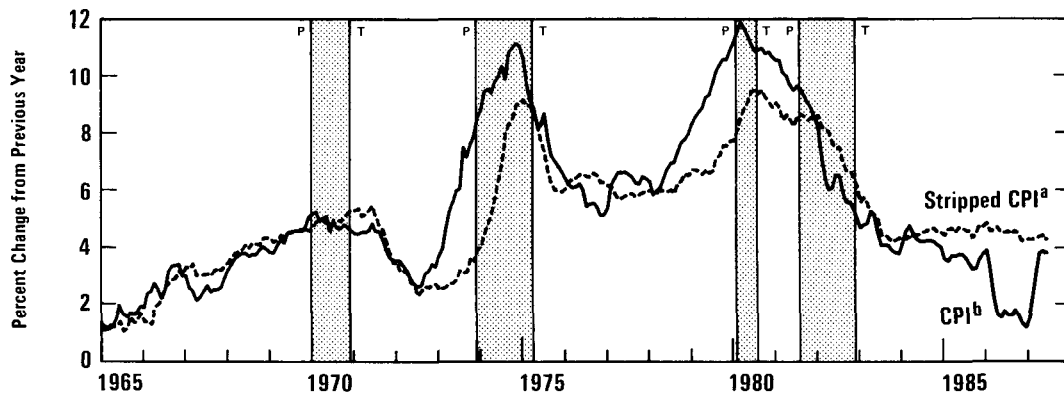
While it is difficult to quantify the influence of these and other factors, most of them seem to point to a reduction in NAIRU since the late 1970s. For instance, the proportion of young people in the total labor force rose rapidly from the early 1960s to the mid-1970s, but began declining markedly in the 1980s. Eligibility standards for many income support programs were tightened considerably during the early 1980s, and the percentage of the unemployed who are receiving unemployment insurance compensation has fallen from 47 percent in 1977 to 33 percent in 1986. Moreover, the proportion of workers belonging to unions has declined substantially since the mid-1970s. These factors tend to reduce NAIRU.

In spite of the variety of factors that may affect NAIRU, past estimates of the change in NAIRU from year to year have generally been able to isolate only the impact of changes in demographics. According to some simple calculations, the change in the age-sex composition of the labor force may have reduced NAIRU by a few tenths of a percentage point between 1979 and 1987, and will reduce it a few tenths more by 1992 (see Appendix B). For this reason, the forecast assumes that NAIRU fell from around 6 percent in 1981 to about 5.7 percent in 1987, and will continue to fall to around 5.5 percent in 1992.

excludes imports). The projected 5 percent trend decline in the exchange rate implies that on average CPI growth will remain above the growth of the GNP deflator through 1992, though by less than during the temporary burst of consumer price inflation that is likely to occur this year and next.

The Outlook for Oil Prices. The average cost of oil imported into the United States is now about \$4 higher than CBO expected in January, mostly because of political developments that have enabled OPEC to tighten its control over production. The fundamentals of the oil market remain roughly as they have been for some time. OPEC could, if it wished, increase output by an amount equal to about 40 percent of total world oil supply outside the Soviet bloc. Worldwide demand remains weak for two reasons: slow income growth, and the residual effects of oil conservation following the very high oil prices of the early 1980s. No significant change in these fundamentals is

Figure I-7.
Measures of Inflation



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

^aCPI-U excluding food, energy, and used cars.

^bCPI-U from January 1983 to present; before that time, the series incorporates a measure of homeownership that is conceptually similar to that of the current CPI-U.

anticipated in the next two years. Thus, oil prices can stay above the \$6 to \$9 range that approximates the unrestricted supply price only if OPEC (and some non-OPEC) producers maintain severe restrictions on their output.⁸ Recently, sharp increases in oil prices have followed news of political troubles in the Persian Gulf region. These increases are probably temporary, the result of precautionary purchases to bolster inventories in the event of a cutoff in Persian Gulf supplies. If there is no cutoff, higher inventories should depress prices, though if CBO's assessment is incorrect and oil prices do not moderate, higher inflation will ensue.

Few forecasters expect any large increase in oil prices in the near future (barring an adverse development in the Persian Gulf), but a sharp drop, though possible, appears less likely than it did earlier this year. This forecast thus assumes very little change in oil prices.

Food Prices. Increases in food prices have remained moderate throughout most of the last half-year. In May and June, meat prices jumped 4 percent, but these increases appear to be the result of a short-run reduction in supply. Meat supplies may remain somewhat short because farmers are holding

8. For CBO's analysis of the oil market, see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1987-1991* (February 1986), pp. 38,39.

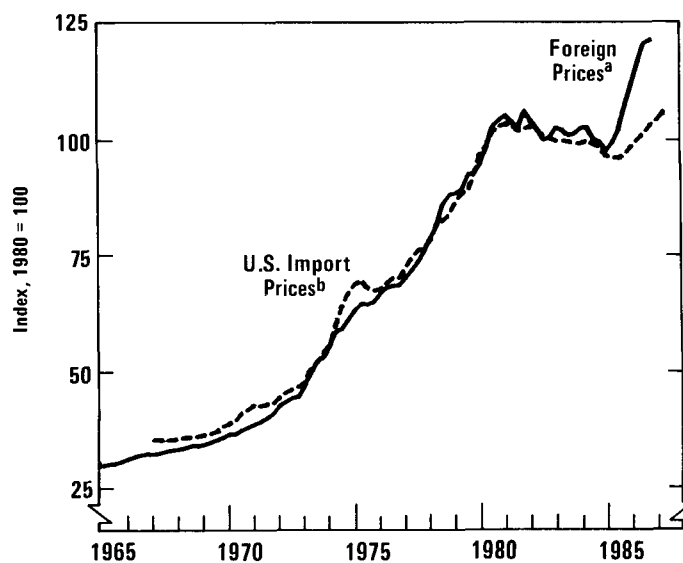
back animals from slaughter to breed them, and feeding their animals up to higher slaughter weights, both of which reduce near-term supplies. In part, these developments stem from the 1985 Food Security Act, which reduced grain prices and thus increased profits in cattle feeding. The larger supplies of meat from the larger herd will not reach consumers for a while.

Import Prices. Large increases in import prices have long been expected as a result of the rapid decline of the dollar since early 1985. But there has been little sign of large price increases for nonpetroleum imports. Those prices have increased at an annual rate of $5\frac{1}{2}$ percent in the last five quarters, but this pace is far less than what would, at least on the basis of past historical performance, be expected to follow such a decline of the dollar. Figure I-8 shows how far U.S. nonpetroleum import prices have lagged behind the level of foreign prices converted to dollars. The reasons for this are not well understood. One frequently invoked factor contributing to this discrepancy is that exporters to the United States apparently gained large increases in profit margins as the dollar rose, and have been slimming these margins rather than raising prices. It is unlikely that this reduction in profit margins will continue indefinitely.

Thus, it seems likely that import prices will increase more rapidly over the next year, probably at double-digit rates for a time. This rise should add

Figure I-8.
Foreign and U.S.
Import Prices

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; International Monetary Fund.



^a Foreign consumer prices converted to U.S. dollars for 18 countries weighted by shares in U.S. nonpetroleum imports.

^b Fixed-weight price index for nonpetroleum merchandise.

about one percentage point a year to the growth of the CPI from mid-1987 through the end of 1988.

Recent Wage Trends and Unit Labor Costs. By any of the most common measures, wage increases continued to be moderate in the first half of the year, particularly for wages in manufacturing. The Employment Cost Index for the private sector was up only 3.0 percent from its level four quarters earlier (see Table I-2 and Figure I-9). Moreover, wage increases have been particularly moderate in the unionized sector of the labor market. Major settlements reached during the four-quarter period ending in June of this year provided for an average wage increase of 1.5 percent in the first year and 2.0 percent annually over the life of the contract.

Real wages have shown little growth during the last decade. In 1980, they fell sharply as a result of higher energy prices. Volatile energy prices had an opposite effect in 1986, as the oil price drop temporarily boosted real wages. So far this year, real wages have been depressed again by higher energy prices.

Foreign competition is one of the major reasons for the low rate of growth of manufacturing wages. Presumably the fall in the dollar will ultimately force foreign suppliers to raise their prices, alleviating some of the competitive pressure on U.S. manufacturers and manufacturing wages.

In view of the strong growth of employment in service-producing industries, wage developments in that sector are of special interest. Even though growth in wages has been higher in the service-producing sector than in the goods-producing sector, the rate of wage growth in the services has remained moderate (see Table I-2). Thus, the Employment Cost Index does not show significant acceleration in wages in either service- or goods-producing industries.

Given the slow growth in wages, employers' labor costs have been rising at only a moderate pace, despite poor productivity performance. Unit labor costs of nonfarm businesses increased at a rate of about 2 percent to 3 percent during 1986 and the first half of 1987. In manufacturing, where wages have been rising more slowly and productivity more rapidly than in the service-producing sector, unit labor costs have been essentially unchanged since early 1986.

The Outlook for Wages. As discussed in the preceding section, wage growth continued to be moderate through the first half of 1987. Most analysts expect that wage growth will increase, particularly in manufacturing,

TABLE I-2. NOMINAL WAGE AND COMPENSATION RATES
IN THE NONFARM BUSINESS SECTOR (Percent
change over similar quarter of previous year)

	<u>1984</u> IV	<u>1985</u> IV	<u>1986</u> IV	<u>1987</u> I II	
Compensation					
Compensation per Man-Hour <u>a/</u>	4.2	4.8	3.4	2.7	2.7
Employment Cost Index <u>b/</u>	4.9	3.9	3.2	3.1	3.0
Union	4.3	2.6	2.1	1.6	1.9
Nonunion	5.2	4.6	3.6	3.6	3.4
Wages and Salaries					
Average Hourly Earnings Index <u>c/</u>	2.8	3.1	2.3	2.2	2.3
Employment Cost Index <u>b/</u>	4.1	4.1	3.1	3.2	3.0
Union	3.4	3.1	2.0	1.7	1.7
Nonunion	4.5	4.6	3.5	3.5	3.3
Manufacturing	4.4	3.6	3.3	2.7	2.4
Nonmanufacturing	4.0	4.5	3.0	3.3	3.2
Service-producing	4.4	4.7	3.0	3.4	3.4
Goods-producing	3.9	3.5	3.2	2.7	2.3
White-collar	4.4	4.9	3.4	3.9	3.3
Blue-collar	3.6	3.4	2.5	2.0	2.3

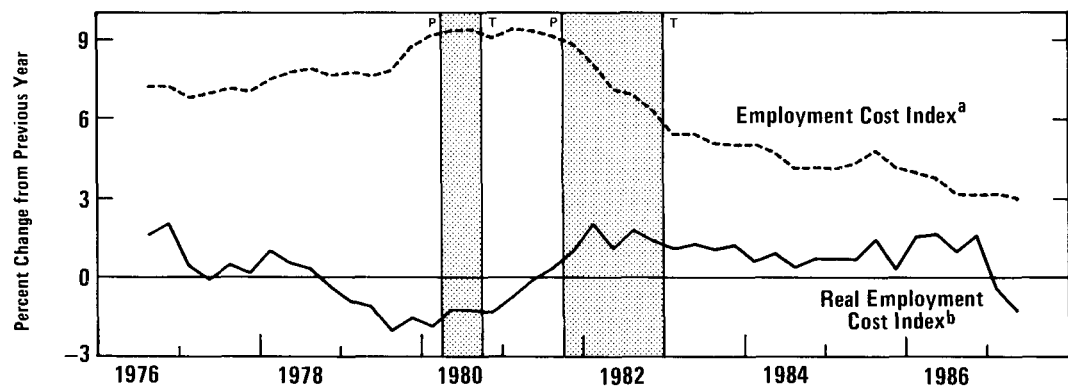
SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics;
Department of Commerce, Bureau of Economic Analysis.

- a. Quarterly data, not adjusted for overtime or for changes in the mix of industries or occupations.
- b. Adjusted for overtime and for changes in the mix of industries and occupations; not seasonally adjusted.
- c. Adjusted for overtime in manufacturing and for changes in the mix of industries.

because of the recent decline in the unemployment rate and because many of the special factors--low food and oil prices--that held down wage growth in the recent past will be reversed. In addition, rapid increases in import prices would raise wage inflation. There is little agreement, however, about the extent of the likely increase. Analysts adduce three main arguments for expecting sharp wage increases:

- o Surges in import prices have sometimes been quite fully reflected in higher wages. When oil and other commodity prices rose sharply in the 1970s, union workers in particular sought, and in part gained, protection from the increased cost of living, setting off a particularly intense inflationary spiral.
- o The decline in the dollar since early 1985 has greatly improved the competitive position of U.S. producers. This is likely to improve both profits and wages.
- o While unions have been weakened by the recession and by foreign trade pressures, some analysts believe that as soon as markets strengthen, unions will again adopt a highly aggressive stance toward wages.

Figure I-9.
Private Nonfarm Wage Rates



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

^aWages and salaries.

^bNominal index deflated by the implicit personal consumption deflator.

But other analysts point to reasons for expecting a continuation of recent moderate wage growth:

- o Despite the decline of the dollar, little trade improvement has yet occurred, and substantial excess capacity still exists. This slack in the economy will work to hold down wage increases.
- o Conditions in labor markets may have fundamentally changed since the 1970s. COLAs, or cost-of-living adjustment provisions in union contracts, are now much less prevalent than they were a decade ago, and a smaller proportion of the work force is covered by collective bargaining agreements.

It is unlikely that even sharply higher import prices will lead to a price-wage spiral and persistently higher rates of inflation, since import price pressures will be offset in part by the excess capacity in the economy. In addition, the Federal Reserve has moved to a less accommodative stance. Hence, wage growth is expected to increase over the next year, but by less than the increase in the CPI--implying a further decline in real wages.

THE COMPOSITION OF DEMAND

The forces behind the economic expansion are shifting from those associated with falling interest rates and low inflation to those associated with an increase in real net exports.

Though GNP grew by 2.9 percent last year, growth was uneven among the various sectors. Falling interest rates and inflation encouraged consumer spending and residential construction. On the other hand, manufacturers remained under intense competitive pressure, and the energy and agriculture sectors were severely depressed. The recent decline in the dollar and increase in oil prices should ease some of these disparities, but CBO's forecast of continued moderate growth rests on the expectation of a large improvement in the real trade balance. Business fixed investment is likely to be sluggish for 1987 as a whole, but it should recover and show strong growth in 1988. Consumer spending growth will be constrained by a low rate of growth of disposable income, and housing is being adversely affected by tax reform and the increase in interest rates. The efforts to reduce the federal deficit are beginning to affect the growth of real federal expenditures on goods and services, and state and local government spending is unlikely to compensate for the decline in federal outlays.

Inventory building may tend to restrain growth in the near term, since nonfarm inventories accumulated rapidly in the first half of the year.

Inventories other than automobiles are still low relative to sales, however. While changes in producers' expectations of future sales can cause rapid shifts in desired inventories, there are no strong reasons to believe that inventories will be a major factor in either restraining or stimulating economic growth over the forecast horizon.

Business Fixed Investment

Real business fixed investment has been in a decline, but the outlook seems to be changing. After two years of strong growth, investment fell 2.3 percent from 1985 to 1986. The weakness was concentrated in spending for structures, which fell by 13 percent in 1986. Investment in commercial structures has been weak because of less favorable tax treatment in the Tax Reform Act of 1986 (which was widely anticipated), and because of high vacancy rates for office buildings. Real spending on equipment decelerated, but still grew by about 3 percent in 1986. This year appears to be one of transition in which little, if any, real growth in investment is anticipated for the year as a whole. But since business investment fell sharply in the first quarter of 1987, holding steady for the year implies fairly solid performance for the rest of the year. Most forecasters expect moderate investment growth to continue in 1988.

One reason for the improved outlook is that the two special factors that depressed investment in structures in 1986 and early 1987--the cutback in oil drilling and the decline in commercial construction--seem to be largely over, though construction of office buildings may continue to be weak for some time yet. Another encouraging sign is the expected turnaround in the real trade balance, which should stimulate sales of manufactured goods and raise manufacturers' profit margins. Several financial factors are also encouraging. Corporate profits and cash flow have held up in spite of sluggish growth, and the stock market has made further gains (see Table I-3 and Figure I-10).

Some other factors are less clearly positive. Capacity utilization, at about 80 percent, is below its average for the 1967 to 1986 period (see Figure I-11); substantial idle capacity acts to depress investment. Orders for real nondefense capital goods--a precursor of changes in equipment investment--have recovered from the dip in the first half of 1986, but do not yet suggest much growth in investment (see Figure I-10). Similarly, the series on new capital appropriations by large manufacturers shows a recovery since the second and third quarters of 1986, but no sign of substantial strength.